Steptoe

2018 Year-End Individual Planning Considerations

December 21, 2018

Almost a year has gone by since the sweeping tax legislation affecting the taxation of corporations, businesses, insurance companies and banks, compensation and retirement savings, exempt organizations, and individuals took effect on January 1, 2018. Of particular relevance to our clients were the increase in the estate, gift and generation skipping transfer tax (GST) exemptions, changes to the individual income tax rates, and the elimination of most individual income tax itemized deductions.

As 2018 comes to a close, Steptoe's private client practice would like to take this opportunity to highlight some of the planning opportunities that may be of interest in areas of wealth transfer, immigration, income tax, and real estate investment planning, as we review the impact of the 2018 Tax Cuts and Jobs Act.

2018 Year End and Immediate Estate Planning Considerations

- Consider making annual gifts. Annual gifts of up to $15,000 per person may be made to an unlimited number of individuals without consuming any lifetime exclusion amount or incurring a gift tax. This amount will remain unchanged in 2019. A married couple together is able to gift $30,000 to each donee in 2018 and 2019. The limitation on annual gifts made to noncitizen spouses is capped at $152,000 in 2018 and will be adjusted for inflation to $155,000 in 2019.

- Review current estate plans to ensure any formula gifts are still appropriate, given the increased exemption amounts.

- Make sure all necessary "Crummey Notices" have been sent to appropriate parties to ensure corresponding gifts made in trust qualify for the annual exclusion (particularly applicable to insurance trusts).

- Maximize annual IRA and other deferred compensation contributions.

- Maximize income tax deductions by making charitable gifts.

Estate Planning to Consider Going Forward Into 2019

- Consider making additional gifts to take advantage of the limited window of time for increased gift tax exemption planning. Gifts made during your lifetime remove both the value of the gifted property as well as any appreciation on that property from your taxable estate, thus minimizing what may be taxed at your death. The basic lifetime exclusion amount doubled as of January 1, 2018 to $10 million and after inflation adjustments will be $11.4 million as of January 1, 2019. This exclusion amount allows for a significant amount of additional lifetime gifting without gift tax consequences.

- Property included in your taxable estate will continue to receive a step-up in basis at your death. Assets gifted during your lifetime will not receive a step-up in basis at death. Therefore, income tax considerations must be taken into account in deciding whether to make lifetime gifts. For those whose total taxable estate is well under the new higher exemption levels it may make sense to consider "undoing" certain plans to bring appreciated assets back into the estate. However, the avoidance of capital gain tax must be weighed against any consequent state level estate taxes on such assets as well as the risk that the assets will appreciate beyond the exemption actually available at the time of death.
- State transfer tax laws must also be taken into consideration. For example:
  - Although New York raised its estate tax exemption incrementally to ultimately match the federal exemption, as of January 1, 2019, with the increased federal exemption, there will continue to be a disconnect between the New York and the federal exemption levels until 2026, when the federal exemption is slated to revert back to $5 million (indexed for inflation).
  - The New York exemption is eliminated entirely for those estates that exceed the state exemption amount by more than five percent.
  - New York also includes certain lifetime gifts made between April 1, 2014 and January 1, 2019 and within three years of death in the decedent's New York taxable estate. Recent legislation, however, limits the gift add back to the estates of decedents who die prior to January 1, 2019.
- As interest rates are still relatively low, but continue to increase, make intra-family loans.
- Review your current estate plan to ensure it appropriately addresses major life events such as a marriage, divorce, or birth of a child or grandchild.
- Consider whether existing trusts need to be decanted to adjust the way property is distributed to certain beneficiaries by changing the trust provisions.
- Review all beneficiary designations to ensure that they do not conflict with your overall testamentary plan.
- Lifetime gifts may be further leveraged by the use of dynasty trusts to which GST tax exemption is allocated. These transfers allow property to pass in trust for the benefit of multiple generations free of estate, gift, and GST tax. Dynasty trusts also are an extremely valuable tool to protect assets from creditors, including spouses in the event of a divorce, to make sure younger generations are protected from having too much wealth in their own hands, and in some cases to preserve unity of ownership.
- Relatively low interest rates continue to make grantor retained annuity trusts (GRATs) and sales to grantor trusts effective planning tools.
- Rising interest rates make qualified personal residence trusts (QPRTs) more attractive and effective planning tools.

GRATs

- A GRAT requires that the grantor retain a fixed annual annuity from the trust for a specific number of years.

- The annuity retained may be equal to 100% of the amount used to fund the GRAT, plus the IRS assumed rate of return applicable to GRATs.
- As long as the GRAT assets outperform the IRS assumed rate of return applicable to GRATs (currently 3.6% for December 2018), at the end of the annuity term the grantor will be able to achieve a transfer tax-free gift of excess appreciation on those assets.
- Under current law, the grantor may structure a GRAT so no taxable gift is made. Therefore, if the grantor survives the annuity term, the appreciation on those assets will pass outside of the grantor's estate without using any applicable exclusion amount or incurring any gift tax.

QPRTs

- A QPRT is a specific type of trust that allows a taxpayer to remove a personal residence from his or her estate at a reduced gift.
- QPRTs allow the grantor to remain living in the residence during the term of the trust; once that period is over, the interest remaining is transferred to the beneficiaries either outright or in further trust as a remainder interest.
- Similar to a GRAT, the value of interest retained by the grantor and therefore the value of the gifted remainder interest is calculated based on the IRS assumed rate of return (currently 3.6% for December 2018). Because the owner retains a fraction of the value, the gift value of the property is lower than its fair market value.
- If the grantor dies before the QPRT term expires, the property is included in the grantor's estate.

How Sales to Grantor Trusts (GTs) Work:

- The grantor of a GT is treated as the owner of the trust assets for income, but not estate tax, purposes. Thus, a grantor may sell assets that are likely to appreciate to a GT in exchange for a reasonable down-payment and a promissory note bearing a minimum required interest rate for the balance. No taxable gain is recognized on the sale and no interest income is recognized by the grantor because the trust is a GT for income tax purposes. So long as the trust assets appreciate by more than the applicable interest rate charged on the note (currently 2.76% for short term loans or 3.31% for long term loans entered into in December 2018), the appreciation over the applicable interest rate on the purchased assets will pass free of estate and gift tax.
- The grantor pays the income tax liability on the GT assets, which allows the principal to grow undiminished by the payment of income taxes. Because the grantor is the owner of the assets for income tax purposes, the grantor's payment of the GT's income taxes is not treated as a gift to the trust beneficiaries even though it results in an increased amount of trust assets available for distribution.

The Aftermath of the 2018 Tax Cuts and Jobs Act and Current Administration Policies

Lifetime Gifting

Federal estate, gift, and GST tax applicable exclusion amounts may be used to make gifts during your lifetime or at death. The amount is capped at $11.18 million for 2018. This amount will increase to $11.4 million for 2019 but, under current law, is slated to revert back to $5 million (indexed for inflation) for decedents dying and gifts made after December 31, 2025.

The increased exemption is a "use it or lose it" opportunity under current law and offers the potential to pass along significant wealth to current and future generations free of estate, gift, and GST tax. When the Tax Cuts and Jobs Act took effect, many taxpayers expressed concern that if the applicable exclusion amounts do revert to $5 million in 2026, there could be a "claw-back" of amounts in excess of that gifted during lifetime. The inclusion of the excess gifted amounts in a decedent's estate could potentially cause an unintended shift in a decedent's total lifetime estate plan. However, the good news is that the IRS issued proposed regulations in November 2018 that confirm no claw-back of used exemption was intended. These proposed regulations, if finalized in their current form, give confidence that current exemption gifting will not be adversely affected if no further changes to the estate tax laws are made.

Qualified Opportunity Zones Offer Great Opportunities to Do Well and Good

As part of the sweeping tax reform last year, Congress implemented the creation of Qualified Opportunity Funds (QOFs), which offer a great opportunity for investors to do well for themselves while doing good for others. Under the legislation, investors can defer tax on capital gains by investing those gains in QOFs, which will put the money to work in projects and businesses in low-income areas called "Opportunity Zones." The regulatory framework for QOFs is still under development, with some final regulations expected in early 2019, but proposed regulations released in October may be relied on currently. Early investors will receive the maximum benefits. Taxpayers that invest in QOFs may defer capital gains until December 31, 2026 (or the earlier sale of the QOF interest) and receive other benefits, depending on how long the QOF investment is held. First, investors may pay less tax on the deferred capital gains if they hold the QOF investment at least five years. Investments held for five years receive a 10% exclusion, so only 90% of the gain is taxed; investments held for seven years benefit from an additional five percent exclusion, for a total exclusion of 15% of the deferred gain. In addition, investors that hold their QOF investments for at least 10 years may have no tax due on the appreciation in their QOF investment. Investments in QOFs need to be made within 180 days of the capital event leading to the gains.

Growing Backlogs Spur Creative US Immigration Strategies

The EB-5 visa category was widely seen as a fast track to US residency for wealthy foreign nationals. EB-5 visa applicants are typically required to make either a $500,000 or $1 million capital investment into a US commercial enterprise, depending on the project and geographical location. Increasing investigations by the SEC and pressure by Congress to end the program combined with long processing times during which time funds are locked in to the EB-5 enterprise has made this immigrant category less desirable. Individuals have to plan long-term and recognize that a "fast track to US residency" is no longer a reality. However, alternatives to permanent residence immigration offer high net worth individuals, as well as entrepreneurs, immigration opportunities that relieve them of some of the burdens involved with the EB-5 program.

State Level Impact and Reactions to Federal Income Tax Changes

Determining the impact of the 2018 Tax Cuts and Jobs Act on an individual's tax liability and the appropriate amount of withholding and/or estimated tax payments for such individual can be more complicated than ever. Because of how certain states have responded to the federal tax changes or as a result of state tax laws being uncoupled from the federal tax laws, anticipated tax liabilities may go up or down at the federal level but may not do the same at the state level.

State Conformity

Some states have taken steps to decouple from some of the federal income tax changes. For example, for federal purposes, alimony payments made pursuant to a divorce or separation agreement signed after December 31, 2018 are no longer treated as taxable income to the recipient or deductible by the payer. New York has decoupled from the federal treatment of alimony payments and allows alimony to be subtracted from federal adjusted gross income in computing New York taxable income. New York also eliminated the requirement to itemize individual deductions for federal purposes in order to itemize for New York purposes. This allows individuals to choose standard or itemized deductions for state purposes even if they do not do so for federal purposes.

Seemingly Unsuccessful Attempts by States to Mitigate the Loss of Deductions

In order to mitigate the cap on the federal deduction for state and local tax taxes, some states and localities created state-operated charitable funds to allow taxpayers to make deductible charitable contributions in exchange for a credit on property taxes. New York passed additional legislation that allows state income taxes paid by an employee to be characterized as payroll taxes (and therefore effectively remain deductible for federal income tax purposes). The IRS, unfortunately, does not view these state workarounds favorably and issued proposed regulations that would eliminate the ability to claim a federal deduction for the portion of a charitable contribution fully offset by a state credit.

529 Plans

Under the new tax laws, limited qualified withdrawals can now be made from 529 plans for kindergarten through high school tuition. Some states, including New York, do not conform to the federal law. Under New York State law, distributions for K-12 tuition expenses are considered nonqualified withdrawals and will require the recapture of any New York State tax benefits that have accrued on contributions.

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